

Negotiable instrument and secured transactions

[Finance](#), [Banking](#)



CPA Regulation Negotiable Instruments and Secured Transactions Negotiable Instruments and Secured Transactions What is a note and who are the parties to a note? © 2011 HOCK international 91 A note is a written promise to pay money. Notes are different from drafts in that notes are a promise to pay. If there is any doubt whether a document is a note or a draft, the holder of the document can decide what it is. There are two parties involved in a note.

1) The Issuer (Maker) is the promisor. This is the party who is obligated to pay the note.

2) The Payee is the person to whom the note is owed. The Payee will receive the money paid by the Issuer. CPA Regulation Negotiable Instruments and Secured Transactions What is a draft and who are the parties to a draft?

© 2011 HOCK international 92

A draft is a written order to pay money. In a draft, one party orders another party to pay money to yet a third party. If there is any doubt whether a document is a note or a draft, the holder of the document can decide what it is. There are three parties involved in a note:

1) The Drawer - The drawer writes and signs the note,

2) The Drawee (usually a bank) - The drawee is ordered by the drawer to pay the Payee, and

3) The Payee - The payee will receive the money from the drawee. CPA Regulation Negotiable Instruments and Secured Transactions What are the common types of notes and drafts?

© 2011 HOCK international 93

The main types of notes are:

- 1) certificate of deposit (a bank promissory note);
- 2) time note (payable at a specific time in the future);
- 3) demand note (payable when it is presented to the issuer); and
- 4) installment note (the principal is payable over time).

The main types of drafts are:

- 1) checks (written on a bank and payable on demand, requiring the drawee to be a bank);
- 2) cashier's checks (a check that is drawn by a bank on itself);
- 3) trade acceptances (a seller of goods writes a draft ordering the buyer to pay at a future time);
- 4) sight drafts (a draft payable when it is delivered); and
- 5) time drafts (a draft payable with a certain period of time). CPA Regulation Negotiable Instruments and Secured Transactions What are the five elements of negotiability? © 2011 HOCK international 94

In order for an instrument to be negotiable, it must have the following five elements:

- 1) It must be in writing and signed by the issuer.
- 2) There must be a sum certain.
- 3) There must be an unconditional promise or order to pay.
- 4) It must be payable upon demand or at a specific time.
- 5) It must be payable either to order or to bearer. CPA Regulation Negotiable Instruments and Secured Transactions What are the requirements for the writing and signature? © 2011 HOCK international 95

A negotiable instrument cannot be an oral communication- it must be written. However, there is no requirement that the writing be on a piece of paper (the writing may be on other items).

Additionally, the instrument must be signed by the issuer, or drawer, to be considered negotiable. The use of any symbol executed or adopted by a party with a present intention to authenticate a writing is sufficient to meet the definition of signed. Thus, a signature can be made manually or by means of a device or a machine, and it can use any name (including a trade or business name) so long as the signatory intends to authenticate the writing. The signature can also be a sign or symbol different from the person's name. CPA Regulation Negotiable Instruments and Secured Transactions

What are the exceptions to a sum certain? © 2011 HOCK international 96

<https://assignbuster.com/negotiable-instrument-and-secured-transactions/>

Though these items appear to contradict the sum certain requirement, the following items do not destroy the negotiability of a note:

- 1) A disparity between the words and numbers on an instrument (in this case the written words are used, not the numbers);
 - 2) A provision for collection costs (including attorneys' fees in the event of the debtor's default);
 - 3) A reference to an exchange rate; and
 - 4) Variable interest rate provisions. However, the instrument must be payable only and completely in money. Thus, a note fails the negotiability test if the note specifies that it is payable in money and/or personal services or goods.
- CPA Regulation Negotiable Instruments and Secured Transactions
What does unconditional mean for a negotiable instrument? © 2011 HOCK international 97

The instrument must be a simple unconditional promise (in the case of notes) or a simple unconditional order (in the case of drafts). Thus, an instrument must be a courier without luggage. This means that the promise or order must not be contingent on some other event happening. If, for example, an instrument says, " I promise to pay, contingent upon satisfactory completion of the terms of the contract signed today...", then the note is not negotiable because it is conditional. However, if instead the instrument says, " As per the contract signed today, I promise to pay...", then this instrument is negotiable because it only makes reference to an underlying contract.

CPA Regulation Negotiable Instruments and Secured Transactions
What types of conditions may exist in a negotiable instrument

without destroying its negotiability? © 2011 HOCK international 98 There are, certain conditions that may exist in the instrument without destroying the negotiability of the instrument:

1) A promise or order is not made conditional if it makes eference to another writing for the statement of rights withrespectto collateral, a prepayment clause, or an acceleration clause or because payment is limited to a particular source.

2) Acceleration clauses enable the creditor to collect more quickly should the debtor not make timely payment. These are permitted because they minimize the burden on creditors and courts.

3) If a promise or order requires countersignature by persons whose signature appears on the promise or order, as condition of payment, this condition does not make the promise or order conditional. This instrument would continue to be negotiable.

The key point regarding negotiability for these types of clauses is whether the amount or certainty of payment is not changed by this clause. If no change will occur, negotiability is not impacted. CPA Regulation Negotiable Instruments and Secured Transactions What are the requirements for the time of payment? © 2011 HOCK international 99

Since the holder of the instrument must be able to determine when it comes due, the instrument must be payable on demand or at a definite time. The time does not need to be a specific date in the future as long as there is reference in the instrument that enables the time o be determined. Despite the fact that there needs to be a date of payment, there is no requirement

that an instrument be dated. Undated instruments are negotiable and are treated as payable on demand by the holder. Instruments may also be antedated (backdated) or postdated. An instrument payable on demand is not payable before the date that is written on its face. It is also possible for the time period for payment to be extended without destroying the negotiability of the instrument. CPA Regulation Negotiable Instruments and Secured Transactions To whom must a negotiable instrument be payable? 2011 HOCK international 100

In order to be negotiable, the instrument must contain the words of negotiability: " payable to bearer" or " payable to order. "

1) An instrument is payable to bearer if it:

a) states that it is " payable to the bearer" or to " the order of the bearer";

b) does not state a payee; or

c) is payable to the " order of cash" or is not payable to an identified person.

An instrument payable to bearer allows whoever holds the instrument to exercise the instrument's rights without indorsement by the maker of the instrument.

2) An instrument payable to order specifies the person o whom payment should be made. Because there is a named payee, until the named person makes a transfer of his rights by indorsing the instrument, the instrument cannot be redeemed for value and cannot be readily transferred to a new holder. CPA Regulation Negotiable Instruments and Secured Transactions List and define the three stages in the life of a negotiable instrument. © 2011 HOCK international 101

<https://assignbuster.com/negotiable-instrument-and-secured-transactions/>

There are three stages in a negotiable instrument's life:

1) Issuance: when the instrument is created and transferred to the first holder, The issuance of the instrument is not a negotiation. 2

) Transfer: when the instrument is transferred from one holder to another

3) Presentment: when the instrument is presented for payment and after payment is made ceases to exist as an instrument. Transfer and presentment of an instrument may constitute a negotiation. Physical transfer of the instrument gives to the transferee (recipient) whatever right the transferor (giver) had in instrument. If the transferee becomes a " holder" of the instrument, then the transfer is called " negotiation. " The way that an instrument is transferred depends on whether the instrument is payable to bearer or to order. CPA Regulation Negotiable Instruments and Secured Transactions How may order and bearer instruments be transferred? © 2011 HOCK international 102

Transfer of Bearer Paper - If an instrument is made out to bearer, the person who physically possesses the instrument is the holder. Since the holder is determined by physical possession alone, a bearer instrument may be transferred simply by giving the instrument to another person. The indorsement (signature) of the previous holder is not required to negotiate bearer paper. Transfer of Order Paper - If the instrument is payable o the order of someone, then the identified person is the bearer once he or she has the negotiable instrument in his possession. However, the negotiation of order paper to another person requires the indorsement by the named party.

CPA Regulation Negotiable Instruments and Secured Transactions What are blank and special indorsements? © 2011 HOCK international 103

Blank indorsement is when the payee simply signs his or her name to the back of the instrument. A blank indorsement automatically converts an order instrument to a bearer instrument. However, the holder of an instrument with a blank indorsement can convert the instrument to order paper by writing a new payee above the blank indorsement. With a special indorsement, if the payee wishes to preserve the order character of the instrument, then the payee may specify a new payee. After this first special indorsement, the signature of the new payee is required for further negotiation of the instrument. If a special indorsement is placed on bearer paper, the special indorsement makes it order paper. CPA Regulation Negotiable Instruments and Secured Transactions What are restrictive and qualified indorsements? © 2011 HOCK international 104

Restrictive indorsement: when the payee adds a condition to the payment of the instrument. Negotiation and further transfer of the instrument are not impaired. Examples are a restriction " for deposit only," or for " payment after the completion of X. " Banks may ignore all restrictive indorsements except those made by the immediate transferor. Qualified indorsement: payee signs his name and adds " without recourse. " Without this statement added to an indorsement, the signatory guarantees payment: if the original parties do not pay, the signatory will. To avoid this liability, the signatory indorses the check with the words without recourse. " A qualified indorsement does not destroy the negotiability of the instrument and does not prevent its transfer. Instead a qualified indorsement makes it order

paper. As a result, it must be indorsed before it can be negotiated. A qualified indorsement eliminates the indorser's contract liability (guarantee of payment), but not his warranty liability. CPA Regulation Negotiable Instruments and Secured Transactions What happens if a negotiable instrument presented for payment is rejected by the payor? © 2011 HOCK international 105

If a payor does not agree to make payment or to accept an instrument that has been presented to them, then the payor has dishonored the instrument. This refusal to make payment gives the instrument holder the right of recourse against the parties with secondary liability. In some cases this process of dishonoring an instrument can be done orally. In other cases written documentation, including a notice of dishonor, is necessary in order to establish legally the secondary liability against other parties to the instrument such as the indorser. CPA Regulation Negotiable Instruments and Secured Transactions What party has primary liability for a negotiable instrument? 2011 HOCK international 106

Primary liability is the liability of makers and acceptors (and sometimes accommodation parties, too). Primary liability means that the maker or acceptor is obligated to pay the instrument before any other party. 1) Maker. This is the party who is obligated to pay a promissory note (not a check - the person who writes a check is called the drawer, below) according to the terms that existed at the time of issuance. 2) Acceptor. The drawee (the bank) has no liability for payment until he accepts the draft. Once the drawee accepts the draft (by signing it), he becomes an acceptor and agrees to pay the draft as presented. Thus, if the acceptor signs an incomplete draft

(for example, the amount is blank), he is liable for any unauthorized amount later filled in. CPA Regulation Negotiable Instruments and Secured Transactions Who has secondary liability for a negotiable instrument? © 2011 HOCK international 107

Secondary liability is the liability that drawers and indorsers have for the instrument. Drawers and indorsers are required to pay for the instrument only if the party with primary liability fails to pay. 1) A Drawer's Liability. The drawer is the person who rote the draft and in so doing ordered another party (usually a bank) to make payment. The drawer does not expressly promise to pay the instrument himself or herself, but implicitly guarantees payment by virtue of using the drawee as a payment agent. In the event that the drawee refuses to pay a draft, the drawer is obligated to pay so long as the drawer is notified of the drawee's dishonor of the draft. 2) An Indorser's Liability. An indorser is someone other than the maker, drawer or acceptor who signs the instrument to negotiate it, restrict it or just to incur liability. The indorser's signature is called an " indorsement. An indorser's liability is created once an instrument has been dishonored and the indorser has been notified of the dishonor. CPA Regulation Negotiable Instruments and Secured Transactions What are the 5 warranties that a transferor makes in respect to the negotiable instrument that is being transferred? © 2011 HOCK international 108

Warranty liability relates to the warranties (promises, or guarantees) that are made by a transferor in respect to the instrument that is being transferred. The transferor warrants that: 1) Good title to the instrument exists and the instrument is enforceable (it is their instrument to transfer).) All signatures

are authorized and genuine (meaning that there are no forgeries). 3) There are no material alterations (for example, the dollar amount has not been increased). 4) The transferor has no knowledge of any insolvency proceedings associated with the instrument. 5) There are no defenses that can be asserted against the transferor that would prevent payment of the instrument. CPA Regulation Negotiable Instruments and Secured Transactions To which parties are warranties made by a transferor of a negotiable instrument? © 2011 HOCK international 109

The parties to whom warranty liability is incurred depend on how the instrument is transferred: 1) Transfer with Indorsement. When the transferor signs the instrument, he or she incurs warranty liability with respect to the immediate transferee and all subsequent (following) transferees. 2) Transfer without Indorsement. If the transfer is made without the indorsement of the transferor, the transferor incurs warranty liability only with respect to the immediate transferee (recipient). Therefore, it is better for the transferor to transfer without indorsement if that is possible. CPA Regulation Negotiable Instruments and Secured Transactions What are accommodation parties and what type of liability do they have? © 2011 HOCK international 110

An accommodation party is a party who signs an instrument as maker, drawer, acceptor or indorser with the deliberate purpose of backing the obligation of another party (the accommodated party). Thus, the accommodation party incurs liability without being a direct beneficiary of the instrument (this is true even if the accommodation party acts as a paid surety; the key is that someone else gets a direct benefit of value given for an instrument). Accommodation parties incur no warranty liability, but they

do incur secondary contract liability just like rawers and indorsers. Additionally, an accommodation party has primary contract liability if he or she signs on behalf of a note's maker. CPA Regulation Negotiable Instruments and Secured Transactions How may liability on an instrument be terminated? © 2011 HOCK international 111

A person who is liable for an instrument can be discharged of some or all of the liabilities through:

- 1) Discharge by Performance (payment of the instrument).
- 2) Discharge by Mere Tender of Payment. The party who offers payment to the holder is discharged from any future liability for collection costs, interest and attorneys' fees.
- 3) Discharge by Cancellation or Renunciation.
- 4) Discharge by Material Alteration. If the amount of an instrument is changed fraudulently, this discharges all previous signatories.
- 5) Certification of a Check by a Bank. This discharges all prior parties to the instrument as the bank becomes primarily liable for the check.
- 6) Unexcused Delay in Payment. With unreasonable delay in the presentation of the instrument, previous signatories may be discharged.
- 7) Discharge Through Release of the Collateral. When collateral is released, the original promisor is also released.

CPA Regulation

Negotiable Instruments and Secured Transactions What are the four requirements to be a holder in due course and what are the benefits? © 2011 HOCK international 112 A holder in due course (HDC) has special status. This status protects an innocent third party (the HDC) from losing his or her investment in a negotiable instrument due to some underlying problem with the instrument. There are four requirements that must be met for a holder to be an HDC:

- 1) Holder. The individual must be a holder of a

<https://assignbuster.com/negotiable-instrument-and-secured-transactions/>

negotiable instrument. 2) Value Given. The holder must have given present or past value (not future value) for the instrument.) Good Faith. The holder must have acted in good faith in the acquisition of the instrument. 4) No Notice of Defect. The holder must take the instrument without notice that the instrument is overdue, has been dishonored, or has been forged. CPA Regulation Negotiable Instruments and Secured Transactions What is a holder under a holder in due course and what are the benefits of this status?

© 2011 HOCK international 113

The transfer of a negotiable instrument gives to the recipient (the transferee) any rights the transferor had to enforce the instrument. This includes the rights as an HDC. This means that when an HDC transfers the instrument to someone else, that recipient automatically has all of the same rights as an HDC. If the recipient meets the requirements as an HDC, they will be an HDC. If, however, the recipient does not meet the HDC requirements (perhaps they received the instrument as a gift), they will be a Holder Under Holder in Due Course (HUHDC) if the transferor was an HDC. This means that it is possible for a person who would not be an HDC (perhaps because he or she knew about some defect or the instrument was overdue) to be an HDC simply because the person from whom they obtained the instrument was an HDC. This is the case regardless of whether the transfer is a negotiation or a gift. CPA Regulation Negotiable Instruments and Secured Transactions What are the real defenses? © 2011 HOCK international 114

When an HDC makes a claim to force payment, the only defenses that the person can use to prevent having to make payment to the HDC are real defenses. Real defenses concern the validity of the instrument itself. By

<https://assignbuster.com/negotiable-instrument-and-secured-transactions/>

using a real defense, the defendant (who tries not to pay) claims that the instrument was never actually an instrument and they never had a liability to that person. They include: 1) Infancy. 2) Duress. 3) Incapacity. 4) Illegality. 5) Discharge in Bankruptcy. 6) Fraud in the Execution. 7) Forgery. 8) Alteration. 9) Subsequent Claims and Defenses. CPA Regulation Negotiable Instruments and Secured Transactions What are the personal defenses? © 2011 HOCK international 115 All other defenses, other than real defenses, are personal defenses. Examples of personal defenses are: 1) Fraud in the inducement; 2) Lack of consideration; 3) Breach of contract; and 4) Mistakes. Personal defenses are ineffective against HDCs. This means that these defenses will not prevent someone from having to pay the HDC.